Second Quarter 2010 Newsletter

Important Custody Changes You Should Know

As you've undoubtedly heard, the Securities and Exchange Commission (SEC), the branch of the government that regulates investment advisors such as Parsec, has modified their regulations in order to protect investors from fraud as a result of the Bernie Madoff Ponzi scheme and other fraudulent activities. One of the rules that will affect Parsec and our clients is a rule concerning custody. Parsec clients know that their assets are held in custody by a third-party brokerage firm such as Charles Schwab, Fidelity or T.D. Ameritrade, not by Parsec. It is very important that this distinction is maintained.

Due to this, we will no longer be allowed to transfer third-party checks from the client to the custodian. In the past we have done this as a courtesy to you but going forward if you mail us a third-party check, we will have to return the check to you and ask you to send the check to the custodian yourself. A third-party check is a check that another party writes to you, and you in turn deposit it into your investment account. As minor as it seems, having this type of check in our possession would indicate custody of this asset – something we must avoid.

You can mail any check for deposit into your account directly to your custodian. In particular, do not send third-party checks to Parsec, as they will be returned to you. Following are the addresses for the three major custodians that we use, as well as instructions on how to deposit third-party checks.

This custody issue also extends to electronic transfers. We are now required to obtain your signature for each third-party electronic transfer. Any current standing letters of authorization to this effect will be void. This includes transfers from an individual's account to a joint account with that individual's spouse. A simple way to conduct these transfers without the hassle of excess paperwork is to log onto your account at the custodian's web site (i.e. Schwab, Fidelity) and initiate the transaction yourself. If you intend to make large or unusual withdrawals from your account, it may be helpful to notify your advisor so he or she can ensure there is cash available for your distribution. Please note that any already-existing, recurring (such as a monthly withdrawal) automatic drafts will not be affected by these rules.

All checks must have "For Deposit Only" written on the back with the account number.

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Special Points of Interest

- **Changes to third-party check handling.**
- **Some certainty to taxes would help a lot.**
- **Patience may be needed for future higher stock prices.**

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To better assist you, here are the addresses for Schwab, Fidelity and T.D. Ameritrade:

Charles Schwab & Co.
Checks made payable to "Charles Schwab & Co." or to the exact account registration type.

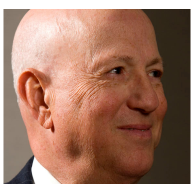
Regular mail:
Charles Schwab & Co.
IST 2
P.O. Box 628290
Orlando, FL 32862

Overnight mail:
Charles Schwab & Co.
IST 2
1958 Summit Park Dr., Suite 400
Orlando, FL 32810

Fidelity Investments
Checks made payable to "Fidelity" or to the exact account registration type.
Fidelity Investments
PO Box 770002
Cincinnati, OH 45277

T.D. Ameritrade
Checks must be made payable to "T.D. Ameritrade for the account of Client Name" -or- "T.D. Ameritrade."
T.D. Ameritrade
4075 Sorrento Valley Blvd., Suite A
San Diego, CA 92121

Dr. Jim Smith's Economic Commentary



Dr. James F. Smith

CHIEF ECONOMIST

The U.S. Economy: Better Than You See, Hear or Read

On June 25, the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce gave us the second revision of GDP data (the "Third Estimate" in their parlance) for the first quarter of 2010 (bea.gov). They told us that real GDP grew then at a seasonally adjusted annual rate of 2.7 percent, a slight reduction from the 3.0 percent pace estimated a month earlier.

Growth in real personal consumption expenditures (PCE) contributed 2.13 percentage points to overall GDP growth and a slowdown in the rate of inventory declines accounted for another 1.88 percentage points. Exports added 1.27 percentage points but imports subtracted 2.09 percentage points (exactly the same as in the fourth quarter of 2009), so net exports deducted 0.82 percentage points. Spending by state and local governments cut another 0.48 percentage points off the growth rate and residential investment, which had added to growth in the two previous quarters, subtracted 0.27 percentage points.

Real GDP was $13,238.6 billion at a seasonally adjusted annual rate in the first quarter. That was up 2.4 percent from the first quarter of 2009 and only $176.7 billion or 1.3 percent less than the record level of $13,415.3 billion set in the second quarter of 2008.

On July 30, BEA will give us the first ("Advance") estimate for the second quarter of 2010. That's also when we'll see revisions to all the data from the first quarter of 2007 through the first quarter of 2010.

While the overwhelming consensus is that real GDP growth exceeded 3.0 percent at a seasonally adjusted annual rate in the second quarter, no one expects a number higher than the old record. However, all the members of the Bloomberg, National Association for Business Economics (NABE) and *The Wall Street Journal* forecasting panels expect that the third quarter of 2010 will set a new record high for real GDP.

That will be good news. It may help banish or at least partially silence all the pundits who spend so much time bemoaning the state of the U.S. economy.

Curing the "Dunkelberg Disconnect" Would Raise the Outlook Dramatically

Dr. William C. Dunkelberg is the chief economist for the National Federation of Independent Business (NFIB-nfib.com), the largest small business membership organization in the U.S. He is also a professor of economics and the former dean of the Fox School of Business at Temple University in Philadelphia.

He has been surveying a broad sample of the NFIB members since 1973, originally on a quarterly basis. The survey became monthly in 1986.

As **Chart 1** shows, that index only dropped below 90 (1986=100) in one quarter from 1978 to 2008. That was in 1980, during the short (six months) but very sharp recession of January to July that year. That was the one that was greatly exacerbated by President Carter's futile efforts to blame inflation on consumers and to use the provisions of the Credit Control Act of 1969 to quell rising prices. (It didn't work.)

The results of that were that Congress repealed the law (a very useful thing for them to accomplish) and the voters elected Governor Ronald Reagan with a majority Republican Senate that November. Small business owners immediately became much more optimistic.

In 2008 and 2009, by dramatic contrast, we saw seven quarters in a row with the Small Business Optimism Index below 90. It finally rose above that level in April and May, reaching 92.2 in May.

Small businesses are very important in the U.S. because they account for about half of GDP and the vast majority of job creation. When they are not investing or hiring, the economy can't grow strongly.

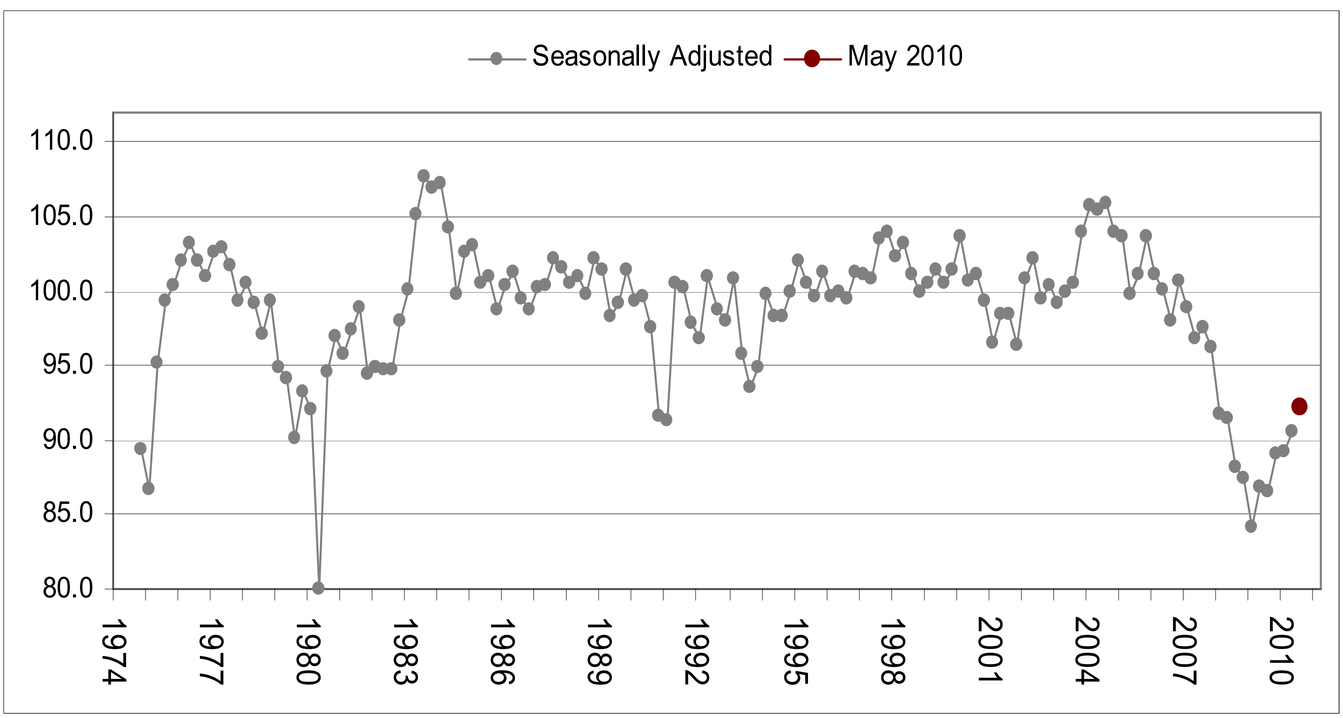
At the same time, the large firms represented in the monthly surveys of purchasing managers conducted by the Institute for Supply Management (ism.ws) have been reporting very strong results for 13 months now. The purchasing managers index (PMI) has been re-

Chart 1

Small Business Optimism Index

(Quarterly, 1986 = 100)

Source: National Federation of Independent Business



ported since 1931. It has a long and distinguished track record of being an excellent early indicator of trends in real GDP and industrial production.

Levels of the PMI above 50.0 percent are consistent with growth in the manufacturing sector. Levels above 42.0 percent are consistent with growth in real GDP.

The PMI is dominated by large manufacturers, most of whom have been a shining light of the economy over the past year. However, the declines in the Euro relative to the U.S. dollar since March may slow that trend later this year and in 2011.

The PMI results have been signaling real GDP growth of around 6.0 percent for the next year or so for some time. At the same time, the Small Business Optimism Index has been predicting very slow growth or none at all.

If approximately half the economy is not growing and the other half is growing at a 6.0 percent pace, the result is 3.0 percent growth. That's certainly better than no growth at all, but is nothing like the strong rebound that historically follows a deep recession.

What would it take to cure or sharply reduce the Dunkelberg Disconnect, that difference between the growth of small businesses compared to large ones? The number one thing would be increased demand for goods and services from both businesses and consumers. A huge proportion of small business owners continue to cite "weak sales" as their biggest single problem. Increased consumer demand and a pick-up in business fixed investment should solve that.

Interestingly, lack of access to credit is a very minor problem for small business owners. They regularly report every month in huge majorities that all their credit needs are being met in a satisfactory manner.

Some Certainty About Taxes Would Help a Lot

No one knows what the tax system will look like in the U.S. in 2011 and beyond. All we know for sure is that all the provisions of the tax cuts enacted in 2001 and 2003 during the Bush Administration are scheduled to expire at midnight on December 31, 2010.

If Congress allows that to happen, it would result in the biggest tax increase in history. It would also probably throw the economy into another recession in 2011.

Because this outcome is considered so awful, all economic forecasters assume it won't happen. Meanwhile, the clock is ticking and Congress has not even started having hearings.

The "Tea Party" crowd is lobbying to get Congress to enact the "Fair Tax" (HR25 or S296). This would send a constitutional amendment to the states to repeal the 16th Amendment, which authorizes the income tax. It would eliminate all current federal taxes (the AMT, corporate and personal income taxes, estate (or death) taxes) and substitute a flat 23.0 percent tax on all purchases of goods and services by consumers with an advance rebate mechanism to households with incomes below $50,000 a year.

This law would obviously create an economic boom and also significantly reduce the budget deficit. It is extremely unlikely that Congress would enact such legislation this year.

There is a growing consensus among "outsiders" that Congress will just punt and let the next (the 112th) Congress deal with the problem. The mechanism for doing this would be to simply extend all the provisions of current law (including the AMT "patch") for one or two more years. An excellent op-ed article in the May 12 edition of *The Wall Street Journal* by Professor Martin Feldstein of Harvard University explains why this action (a two-year extension) would be a very good idea.

Members of Congress have a very convenient excuse to enact such a law. President Obama has created the National Commission on Fiscal Responsibility and Reform to recommend ways to reduce the deficit and look at both the tax code and ways to hold down the growth of entitlement spending, most of which is due to Medicaid and Medicare along with Social Security.

This commission is co-chaired by former Republican senator (1979-1997) Alan Simpson of Wyoming (a cousin of Queen Elizabeth II of the United Kingdom) and Erskine Bowles, president of the University of North Carolina system and a former White House Chief of Staff under President Clinton. In that position, he worked with Republican leaders in Congress to pass the "Balanced Budget Act of 1997," which led to budget surpluses in fiscal years 1998, 1999, 2000 and 2001.

It is supposed to issue its report in December 2010. If 14 of the 18 members (10 Democrats and 8 Republicans) can agree on any ideas, these will become "official" recommendations. Note that this due date is well after the elections on November 2. This is no coincidence and it makes it very convenient for this Congress to leave the hard decisions to the next one.

At the G-20 summit in Toronto on June 26-27, the large developed countries all agreed to cut their budget deficits in half by 2013. That would only get the U.S. down to a 5.0 percent deficit, which is still way too high.

We ought to be able to run budget surpluses again. One easy way to do it would be to look at the details of government spending in the 1998 to 2001 period as shares of nominal GDP and try to return to whatever those budget proportions are.

We are either going to see many government programs disappear entirely or shrink dramatically in the next twenty years or we are going to see big changes in Medicaid, Medicare and Social Security. There simply won't be enough money to go around to keep doing what we've been doing or anything remotely like it.

The Outlook Is Pretty Good

The U.S. economy seems to be growing steadily. As stated above, the third quarter of 2010 should see us in new record territory for overall economic activity.

Barring a successful terrorist attack in North America, a failure of Congress to enact a tax law that would keep the huge fiscal drag from hitting in 2011 or a sustained run of oil prices above $100 a barrel, it is very hard to see what could derail steady economic growth for many years to come. It sure won't be inflation, as there is absolutely no chance for that to be a problem for many years, if ever.

The housing sector is fairly weak, but it will gain strength. The tax credit that expired on April 30 pulled some sales ahead, but by the fall we should see renewed activity.

With over 15,000,000 people unemployed and looking for work, it would obviously be wonderful news to see over 400,000 people a month returning to the ranks of the employed. Until we shrink or eliminate the factors causing the Dunkelberg Disconnect, that won't happen, but it will after that.

Retail sales have returned to levels not seen since the government allowed Lehman Brothers to collapse on September 15, 2008. Rising employment and disposable personal income will result in new records in this very important area in 2011 for sure.

The growth in labor productivity, whether defined as output per hour or per worker, has soared in the last two quarters. This will slow down, but it will stay in the 2.6 to 2.9 percent range on an annual basis, which will guarantee good growth going forward.

Consumers will continue to see their net worth grow. Eventually it will surpass the 2007 records.
On June 10 the Board of Governors of the Federal Reserve System told us that consumers had total assets of $68.5 trillion on March 31, 2010, which was the highest since 2007. After subtracting liabilities of $14.0 trillion, our net worth was $54.6 trillion. That was an increase of $6.3 trillion or 13.0 percent from the first quarter of 2009.
The value of our houses was $16.5 trillion on March 31. That was up $823.2 billion or 5.2 percent from a year earlier. Un-borrowed home equity was $6.3 trillion on March 31. That was 38.0 percent of the value of our homes, up from 33.1 percent a year earlier.
The proportion of good economic news to bad economic news grows on a weekly basis. We will never get the good news slice to 100 percent, but it's around 60 percent now, and before long will be in the 80 percent range. That should cut down some of the "gloom and doom" talk.

Stock Market Perspective

Rick Manske, CFP®

Managing Partner

The subprime meltdown that set off the worldwide financial crisis and earned the dubious moniker “the Great Recession” has significantly altered investor expectations. Increasingly, the average American feels shut out of the financial markets as flash trading firms and hedge funds become the dominant participants in the daily volume of stock trading. These short-term trading strategies tend to increase market volatility, further alienating Main Street investors. The notion that the financial markets are rigged against the traditional buy-and-hold investor has many clamoring for something new and different. In an environment such as this, many investors fall victim to the somber mood and begin to position their portfolio too defensively. Portfolio asset allocations that do not include enough stocks only exacerbate the problem of underfunded retirements. With today’s low interest rates, cash equivalents are paramount to admitting defeat in planning for a successful retirement. Even if the new normal in the global economy is slower growth, stocks will be a critical component to every pension fund, endowment, and individual investor’s portfolio.

The banking losses incurred during the financial crisis were aggressively dealt with by government policy makers. The Federal Reserve and Treasury department utilized emergency monetary and fiscal policy to shock the credit markets and economy back to life. To a large extent, these measures were successful in stabilizing the financial system. However, the problems were not entirely solved; rather, the problem moved as the losses incurred in the financial sector were essentially socialized and put onto the balance sheet of the government. The next phase of the recovery is marked by governments having to contend with unsustainable budget deficits and high levels of debt. We see this most clearly in Europe but can also see our own budget challenges here in the U.S.

Many Americans have allowed their fear of the national debt and continuing budget deficit to impede upon prudent decision making. The media bombards us with the comments from the extreme left and right, leaving the majority greatly alarmed and feeling somewhat paralyzed. I believe that most Americans understand tough steps will need to be taken to correct the imbalances. Like what has occurred in their own households, they understand that our federal and state governments will need to enact austerity campaigns of their own. With the blunt reality of the moment, I feel confident that Americans will act to arrest the deterioration of our government’s balance sheet.

A key component to rectify the budget woes resides in the recovery in economic activity and corporate earnings into a self-sustaining cycle. This process has begun with rising corporate earnings that are solidly above levels of a year ago. As company executives develop confidence that the self-sustaining cycle has momentum, they will begin to hire back employees. While we wait for the momentum to become obvious to all, we must not allow the mood of the day to capture us into thinking a zero return asset like cash is good, or a precious metal without a dividend or market as a currency is somehow what is right for our portfolios. Instead we must determine what our short- and intermediate-term spending and emergency fund needs are and meet those needs in bonds. For our long-term goals, we advise that you continue do what is the most difficult currently. You must allocate to stocks an amount that will accomplish your goals, and then you must have patience as we wait for higher stock prices in the future.

The Case for the Charitable Remainder Unitrust

Neal Nolan, CFP®

Financial Advisor

With the passage of the Healthcare Reform Bill, some investors may be unaware of certain tax changes contained therein. Of particular interest are higher future income taxes and the Medicare surtax on investment income for high income earners (income of $200,000 for Single filers and $250,000 for Married Filing Jointly). Naturally, with an increase in taxes comes the desire to find ways of reducing one's tax liability. While there is no single silver bullet that addresses this problem, individuals working with qualified tax, financial planning, and estate planning professionals have found that there are many strategies to reduce both present and future taxes. One such strategy that appears to be gaining renewed interest is called the Charitable Unitrust, more commonly referred to as a Charitable Remainder Trust (CRT).

The rules and laws that govern CRTs are somewhat complex. However, it may be helpful to think of CRTs as an investment account in which assets can be gifted to the donor's charity of choice. This can be especially beneficial to those interested in lowering their estate tax liability, as these investments are effectively removed from the estate. Once the donation is made, the donor is allowed a current-year tax deduction based on the "actuarial present value" of the gift. An additional tax benefit is recognized as the donor may then sell a highly appreciated asset within the CRT without recognizing any capital gains tax. Investment advisors would then advocate that the proceeds be reinvested in a diversified manner.

What makes the CRT unique is that the trust has two beneficiaries – the income beneficiary and the remainder beneficiary (the charity). During the donor's life, the trust distributes a portion of the property back to the donor as an income stream. The IRS has mandated a minimum percentage rate of 5% of the yearly appraised value of the property within the trust. Upon the donor's passing, the trust's remaining assets are then distributed to the charity.

The Charitable Remainder Trust comes in a few varieties; the remainder of this article will generally refer to the Charitable Remainder Unitrust or "CRUT." The CRUT has specific rules allowing for multiple donations and offers a variable annual income stream. This differs from the annuity form of the CRT (called the "CRAT" or Charitable Remainder Annuity Trust) which only allows for a one-time donation and a fixed-dollar income stream. Because the income received from a CRUT is based on the performance of the underlying investments, the donor's income distribution should be able to keep pace with inflation and rise with time. Also, since the CRUT allows for multiple gifts with multiple tax deductions, the donor has the ability to further increase future income distributions.

Because donations to the CRT enjoy a current year tax deduction and provide an additional source of retirement income, high income earners who are relatively close to a normal retirement age may be interested in incorporating the CRUT into their estate planning. Assuming that work-sponsored retirement plans and IRAs are maximized, the high income earner has few other opportunities to reduce his or her income on page one of the IRS's 1040. Thanks in part to the recently passed healthcare legislation and the included increased Medicare payroll tax (2.35%) and surtax on investment income (3.8%), the additional deduction is appealing. Such donors should work with a tax and investment professional to carefully calculate the tax benefits and investment choice. Any unused deduction must be used within the next 5 years, thus making the multiple donation nature of the CRUT a likely more favorable choice of vehicle.

Typically, these accounts are funded with low-basis, highly appreciated investment assets or real estate. However, as an interesting side note, the Pension Protection Act of 2006 made possible the direct funding of charities from one's Required Minimum Distribution (up to $100,000), but without recognizing the transaction as income (and no income taxes either). Sadly, this provision expired in 2009. As of this writing, the House has passed a bill (H.R. 4213) that would extend the charitable IRA deduction through 2010 and is pending further congressional discussion.

Many worthy charities are searching for new donors, especially in the wake of the economic recession of 2008-2009. No doubt, potential donors are keenly aware that the stock market and economy are still recovering. Yet they are left scratching their heads trying to figure out a win-win scenario: how to make a charitable contribution, yet ensure their own retirement spending needs are not jeopardized? The CRT remains a strong answer to this question.

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